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No. 01-1880

In The Supreme Court of the United States

WALTER L. AND BARBARA H. GROSS, JR.;
CALVIN C. AND PATRICIA G. LINNEMANN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

BRIEF OF *AMICI CURIAE* NATIONAL ASSOCIATION OF MANUFACTURERS, THE S CORPORATION ASSOCIATION, THE ASSOCIATED INDUSTRIES OF MASSACHUSETTS, THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, THE NFIB LEGAL FOUNDATION, THE SOUTH CAROLINA CHAMBER OF COMMERCE, THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY, AND THE BUSINESS COUNCIL OF ALABAMA IN SUPPORT OF THE PETITIONERS

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QUESTION PRESENTED FOR REVIEW

Can the Internal Revenue Service introduce a new standard of valuation during adjudication, and then apply it retroactively?

PARTIES TO THE PROCEEDING

The parties below were petitioners Walter L. and Barbara H. Gross, Jr. and Calvin C. and Patricia G. Linnemann (Petitioners-Appellants below) and respondent Commissioner of Internal Revenue (Respondent-Appellee below).

The *Amici* filing this brief are the National Association of Manufacturers, the S Corporation Association, Associated Industries of Massachusetts, the National Association of Wholesaler-Distributors, the NFIB Legal Foundation, the South Carolina Chamber of Commerce, the Association for Manufacturing Technology and the Business Council of Alabama.

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iv
BRIEF *AMICI CURIAE*	1
INTERESTS OF THE *AMICI CURIAE*	1
SUMMARY OF ARGUMENT	7
I. The Commissioner's Arbitrary Adoption Of An Appraisal Methodology Inconsistent With Prior Practices And Procedures Is Prohibited By Law	8
II. The Commissioner Cannot Introduce At Trial And Apply Retroactively A New Valuation Method That Is Contrary In Result To The Established Practices Of The IRS	10
CONCLUSION	12

TABLE OF AUTHORITIES

Page

CASES

Adams v. Commissioner, TC Memo 2002-80, 83 T.C.M. (CCH) 1421 (March 28, 2002) 10

Bowen v. Georgetown University Hospital, 488 U.S. 204 (1988) 11

E.W. Bliss Co. v. United States, 224 F.Supp. 374 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965) 8

Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981) 8

Ford Motor Co. v. FTC, 673 F.2d 1008 (9th Cir. 1981) 10

Gross v. Commissioner, 272 F.3d 333 (6th Cir. 2001) 7, 8

Hall v. Commissioner, 34 T.C.M. (CCH) 648 (1975) 9

Longhi v. Animal & Plant Health Inspection Service, 165 F.3d 1057 (6th Cir. 1999) 11

Maris v. Commissioner, 41 T.C.M. (CCH) 127 (1980) 9

NLRB v. Wyman-Gordon, 394 U.S. 759 (1969) 8

Pfaff v. HUD, 88 F.3d 739 (9th Cir. 1996) 10,11

SEC v. Chenery Corp., 332 U.S. 194 (1947) 11

STATUTES

Employee Retirement Income Security Act of 1974 ("ERISA") §408, 29 U.S.C. §1108 5

ERISA §103, 29 U.S.C. §1023 6

TABLE OF AUTHORITIES – Continued

Page

RULINGS

Rev. Rul. 59-60 §4, 1959-1 C.B. 237 9

OTHER AUTHORITIES

I.R.M. 4350, *IRS Examination Technique Handbook*, 7(11)9 (Dec. 16, 1987) 9

IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers, pp. 7-14 (Jan. 28, 1994) 9

BRIEF *AMICI CURIAE*

Pursuant to Rule 37.2(a) of the Rules of this Court, on written consent of all parties filed with the Clerk of the Court concurrently with this Brief, the National Association of Manufacturers, the S corporation Association, Associated Industries of Massachusetts, the National Association of Wholesaler-Distributors, the NFIB Legal Foundation, the South Carolina Chamber of Commerce, the Association of Manufacturing Technology and the Business Council of Alabama respectfully submit this Brief *Amici Curiae* in support of Petitioners seeking a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.[1]

INTERESTS OF THE *AMICI CURIAE*

Amici Curiae are associations that have a substantial interest in ensuring the proper valuation of business entities, and, in particular, corporations subject to tax rules under Subchapter S of the Internal Revenue Code, so as to provide predictable values for such entities in conducting their business affairs.

The National Association of Manufacturers ("NAM") is the nation's oldest and largest broad-based industrial trade association. The NAM represents 14,000 members

[1] Pursuant to Supreme Court Rule 37.6, *Amici* state that no person or entity other than *Amici*, their members, or their counsel made a monetary contribution to the preparation or submission of this Brief. Further, no counsel for any Petitioner or Respondent authored this Brief in full or in part.

(including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in 50 states. Of its 10,000 small and mid-sized company members, the NAM estimates that approximately 4,500 are governed by the provisions of Subchapter S of the Internal Revenue Code.

The S Corporation Association ("S-CORP") is the only association solely representing Subchapter S corporations in America. S-CORP represents a large and growing number of S corporations, most of which are family and other small businesses. The members of S-CORP have a direct and overriding interest in the appropriate valuation of S corporation stock so as to provide certainty and a proper level of taxation for business and planning transactions.

Associated Industries of Massachusetts ("AIM") is the largest nonprofit, nonpartisan employer association in the State of Massachusetts with more than 6,400 member companies. It represents a wide range of companies including manufacturers, Fortune 500 firms, high technology firms, professional service firms, colleges and universities and industrial establishments. Its average member employs 50 or fewer people, and it estimates that approximately 500 of its members are S corporations.

The National Association of Wholesaler-Distributors represents approximately 45,000 wholesaler-distributors through a federation of over 100 national line-of-trade associations. The vast majority of these are small- to medium-sized businesses, many of which are Subchapter S corporations.

The NFIB Legal Foundation is the legal arm of the National Federation of Independent Business ("NFIB"),

which is the nation's oldest and largest organization dedicated to representing the interests of small-business owners throughout all 50 states. The approximately 600,000 members of NFIB own a wide variety of America's independent businesses, from grocery stores to bowling alleys to construction firms. NFIB estimates that over 23 percent of its members are S corporations.

The South Carolina Chamber of Commerce is South Carolina's largest broad-based business and industry trade association representing more than 2,400 corporate members ranging in size from one employee to more than 20,000 employees and more than 100 local chambers of commerce and statewide business trade associations. The South Carolina Chamber represents the interests of approximately 500 S corporations.

The Association For Manufacturing Technology ("AMT") is a 100-year-old trade association that represents approximately 360 machine tool building and related product firms located throughout the United States. AMT members build and provide the tools for manufacturing technology to a broad and diverse array of industries, including automotive, defense, electronics and appliances. Many of AMT's small- and medium-size members, as well as some of their large members, are S corporations.

The Business Council of Alabama ("BCA") is the state's leading association of business and industry and comprises nearly 5,000 member businesses from every county in Alabama. The BCA is a member-driven organization recognized as Alabama's strongest advocate for free enterprise. An appreciable number of the BCA's members are S corporations.

The common interest of *Amici* is to ensure that courts apply the standard for determining fair market value properly. A consistent and predictable standard is essential to estate and gift tax cases (as in the instant case), and impacts potentially hundreds of thousands of (i) business owners and (ii) employees who are the beneficiaries of pension funds investing in S corporations.

The Regulations to the Internal Revenue Code at §20.2031(b) define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts" (hereinafter the "Willing Buyer-Willing Seller Standard"). Virtually identical language also appears in Treas. Reg. §25.2512-3 for purposes of determining fair market value of any interest in a business for gift tax purposes. The proper application of the Willing Buyer-Willing Seller Standard for estate and gift tax purposes can have a powerful effect on S corporations, many of which are members of *Amici*, and all of which are closely held and/or family businesses.

Estate and gift taxes pose a significant challenge to a family business's ability to remain financially viable upon passage from one generation to the next, a consequence of wealth transfer taxation that is well documented. Exorbitant and inappropriate taxation, based on application of an improper Willing Buyer-Willing Seller Standard, can only exacerbate the financial difficulty that these small businesses face when passing from generation to generation. The complex nature of the estate tax and family business succession planning makes proper planning for a liability quite expensive, even for the average business. Satisfying the standards for proper planning are made

dramatically more difficult in an environment, brought about by this case, which is in a permanent state of change. Moreover, the effect on the economy as a whole will be dramatic, because small businesses (and Subchapter S corporations, which are a significant portion of America's small business community) as a group are one of the major drivers for job creation and economic growth in America. Accordingly, a proper formulation of the Willing Buyer-Willing Seller Standard is imperative.

The impact of the Willing Buyer-Willing Seller Standard is also felt well beyond the area of taxation. For example, since January 1998, Internal Revenue Code §1361(c)(6) has permitted employee stock ownership plans ("ESOPs") to hold shares in S corporations. An ESOP is subject to regulation both within and without the context of taxation that requires it to determine the value of the S corporation stock in several key circumstances. For example:

- The Employee Retirement Income Securities Act of 1974 ("ERISA"), which governs retirement plans in general and ESOPs in particular, prohibits transactions that occur for less than adequate consideration.[2] In all such transactions, the valuation or appraisal of S corporation stock must make use of the Willing Buyer-Willing Seller Standard.
- ERISA imposes an annual reporting requirement which mandates the preparation and audit of a

[2] Employee Retirement Income Security Act of 1974 ("ERISA") §408, 29 U.S.C. §1108.

financial statement, a requirement which necessitates a proper valuation of the ESOP's S corporation stock holdings which must be appraised annually based on the Willing Buyer-Willing Seller Standard.[3]

- Upon creation of an ESOP, owners of a Subchapter S corporation will often sell shares of their stock to the ESOP. In such cases, only a predictable and consistent application of the Willing Buyer-Willing Seller Standard can ensure that the selling shareholders, the ESOP and its employee-participants are treated fairly.

As these examples indicate, anything less than an accurate appraisal of an ESOP's S corporation stock holdings, conducted with a proper application of the Willing Buyer-Willing Seller Standard, results in a misstatement of the value of every account of every employee-participant in the ESOP. If the Willing Buyer-Willing Seller Standard is applied inconsistently or improperly, the resulting misstatements can impact the retirement plans of potentially hundreds of thousands of individuals who currently participate in ESOPs, as well as all other non-ESOP owners of such stock.

In view of the foregoing, members of *Amici* have a substantial interest in the outcome of the instant case. Inappropriate estate and gift taxation, through improper application of the Willing Buyer-Willing Seller Standard, will substantially burden S corporations by imposing excessive tax burdens, which will in turn strain corporate capital and continuity of ownership for closely held and/or

[3] ERISA §103, 29 U.S.C. §1023.

family business entities. Such a burden is particularly onerous for Subchapter S corporations, which are limited in capital structure to a single class of stock, and which capital structure effectively prohibits them from accessing public capital markets to deal with tax liabilities. As discussed above, the requirements of ERISA in non-tax areas also require proper application of the Willing Buyer-Willing Seller Standard.

Amici view the rulings at issue in this case as a serious threat to their members' appropriate interests in a predictable legal environment for tax planning and other financial transactions.

SUMMARY OF ARGUMENT

Petitioners herein seek a writ of certiorari to the United States Court of Appeals for the Sixth Circuit to redress the inequity resulting from the retroactive application by the IRS of what, in effect, was a new rule of law, in violation of Petitioner's right to due process. The decision of the Court of Appeals for the Sixth Circuit, *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001), which allows excessive and inappropriate taxation through improper application of the Willing Buyer-Willing Seller Standard, also permits a lack of predictability in the valuation of S corporation stock that is prohibited by law. *Amici* file this brief because of their shared concern that the retroactive application of rules by the IRS, made in the course of litigation involving the value of S corporation stock, will have implications far beyond the instant case and will materially and adversely impact normal business and

planning transactions for America's 2.4 million S corporations, many of which are members of *Amici*.

ARGUMENT

I. The Commissioner's Arbitrary Adoption Of An Appraisal Methodology Inconsistent With Prior Practices And Procedures Is Prohibited By Law

In the instant case, the Commissioner has acted in violation of a clear principle of law which exhorts agency predictability over capricious changes in policy made solely in pursuit of increased tax revenue. The Internal Revenue Service ("IRS") must "establish practices and procedures that are consistent and predictable, not subject to the whim of the Commissioner." *Gross v. Commissioner*, 272 F.3d at 349, citing *Estate of Bright v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981). Furthermore, absent unusual circumstances, these practices and procedures must be formulated through statutorily-prescribed rule-making procedures, not through ad hoc agency changes in policy. See *NLRB v. Wyman-Gordon*, 394 U.S. 759, 764 (1969). Finally, changes in procedure cannot be enacted retroactively where the existing regulations are "broad enough to allow a taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices, and one which was consistently followed." *E.W. Bliss Co. v. United States,* 224 F.Supp. 374, 384 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965).

Amici are certain that allowing the Commissioner in this case to deviate from its past application of the Willing Buyer-Willing Seller Standard will create exactly the type

of uncertainty in valuation methods that the above-stated legal principle is intended to prevent. Tax affecting is a component of valuation methodology that has been acknowledged and accepted by the courts, see, e.g., *Maris v. Commissioner*, 41 T.C.M. (CCH) 127, 138 (1980) and *Hall v. Commissioner,* 34 T.C.M. (CCH) 648, 667 (1975), and Rev. Rul. 59-60 §4, 1959-1 C.B. 237, which sets forth the parameters of the Willing Buyer-Willing Seller Standard, is certainly "broad enough" to permit tax affecting in Petitioners' case.[4] Furthermore, prior to the instant case, it is clear that the IRS not only approved of tax affecting as a proper component of S corporation stock appraisals, but routinely advised its own agents to tax affect S corporation stock "to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made." *IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers*, pp. 7-14 (Jan. 28, 1994); see also I.R.M. 4350, *IRS Examination Technique Handbook*, 7(11)9 (Dec. 16, 1987) (providing that S corporation income must be adjusted using corporate tax rates when comparing the stock of an S corporation to a similar firm that is publicly traded). Under *Bliss*, where a taxpayer's valuation method "is substantially in accord with the regulations, great weight must be given to its long record of consistent application of the same method." The Sixth Circuit failed to give such weight to Petitioners' appraisal in this case, and, as a

[4] Section 4 of Revenue Ruling 59-60 provides that "in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as relevant factors affecting the fair market value, should be considered."

result, its decision calls into question the innumerable appraisals of S corporation stock upon which members of *Amici* must rely, both for tax and non-tax business purposes.

II. The Commissioner Cannot Introduce At Trial And Apply Retroactively A New Valuation Method That Is Contrary In Result To The Established Practices Of The IRS

The Sixth Circuit, in affirming the Tax Court's acceptance of a new IRS policy which abandons tax affecting, acted in contravention of established principles that disfavor retroactive application of a new rule that has been adopted by adjudication. See, e.g., *Pfaff v.* HUD, 88 F.3d 739, 748 (9th Cir. 1996), citing *Ford Motor Co. v. FTC*, 673 F.2d 1008, 1009 (9th Cir. 1981). The Commissioner's position at trial in the Tax Court represents the first instance in which the IRS has publicly announced any policy position inconsistent with tax affecting S corporation stock when valuing such stock pursuant to the Willing Buyer-Willing Seller Standard. The IRS has also made clear that its position in the Tax Court does indeed represent a reversal of policy and not a case-specific variation in its valuation methods that it intends to limit to the facts of Petitioners' case. See *Adams v. Commissioner,* TC Memo 2002-80, 83 T.C.M. (CCH) 1421 (March 28, 2002), in which the Commissioner cites the Sixth Circuit's decision in Petitioners' case as precedent for a general rule disallowing tax affecting.

Commissioner's position at trial was not supported by IRS policies, as discussed above, nor by its past acceptance of Petitioners' own tax affecting practices; thus, Commissioner's attempt to evade application of tax affecting to

Petitioners' case constituted an adoption of a new regulatory policy that it applied improperly to a previous year's tax return. While *Amici* do not contest the right of an agency to change its policies prospectively where appropriate and when in compliance with all procedural requirements, they agree with the many courts that have made clear that such changes in policy should not be applied retroactively. See, e.g., *Longhi v. Animal & Plant Health Inspection Service*, 165 F.3d 1057, 1061 (6th Cir. 1999); *Bowen v. Georgetown University Hospital,* 488 U.S. 204 (1988); *SEC v. Chenery Corp.*, 332 U.S. 194 (1947).

The Ninth Circuit, for example, has struck down an agency's attempt to impose a new policy change retroactively "where the new standard, adopted by adjudication, departs radically from the agency's previous interpretation of the law, where the public has relied substantially and in good faith on the previous interpretation, where fines or damages are involved, and where the new standard is very broad and general in scope and prospective in application." *Pfaff v. HUD*, 88 F.3d at 748. The Commissioner, in Petitioners' case, promulgated a new methodology for S corporation stock valuation during a 1996 trial which he then sought to apply to Petitioners' 1992 tax returns, an act which clearly rises to the level of retroactive application of a new standard. Furthermore, as indicated by the IRS's own internal training manuals, tax affecting S corporation stock was a routine agency policy upon which the public, including both Petitioners and the members of *Amici,* has routinely relied in good faith. Should the members of *Amici* find themselves exposed to retroactive valuations of their stock that make use of an entirely different valuation methodology, the legal and financial consequences to both

their shareholders and their employees will have a profound and detrimental impact on a substantial segment of America's economy.

CONCLUSION

The petition for certiorari should be granted and the Sixth Circuit's decision should be reversed.

Respectfully submitted,

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